Rates Spark: Still some upside risks for yields ahead

While US CPI seems to have collapsed, a lot of this is from exceptional factors. The real underlying number is closer to 0.4% MoM in services. Bond yields will test further lower, but there is a limit to that (c.3.25%). A reversion higher (to 3.75%) remains a risk as we move into the first quarter. Look for 50bp from the Fed today, and more to come in Q1.

US inflation not as straightforward as seems

Falls in real rates and inflation expectations were seen post the CPI number. This solidifies the remarkable recent move in the 10yr from 4.25% to 3.5%, and now approaching 3.4%. The terminal fed funds rate discount has also been shaved lower. It was comfortably discounting a peak at 4.75-5%. It is still in that range, but now toying with pulling that lower, to 4.5-4.75%. The 10yr is more than100bp below this still, which is quite a yield discount. It limits the room for a big move to the downside from here.

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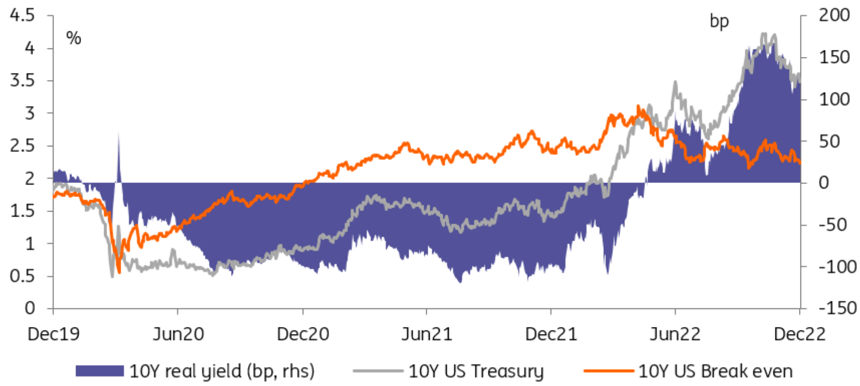
It feels like the marketplace has done a remarkably good job at anticipating this number, but as always we need to see some repeats before we can conclude that the inflation fighting job is done. The 20bp fall in the 2yr yield to sub-4.2% reflects the same theme, and is now at a sizeable 75bp discount to the market discount for the terminal funds rate.

The bond market is trading as if the Fed delivers 50bp today, and then they are done. In all probability the Fed is not done, but if this number proves to be the beginning of a theme of low inflation prints, its increasingly likely that any hikes in the first quarter will be insurance ones, a far cry from the panic stations of previous months that saw consecutive 75bp hikes.

Real yields have led the move lower in USD rates



Source: Refinitiv, ING

Downside to 10Y yields is more limited from here

The market has been increasingly sensing this, with the 5yr trading remarkably rich to the curve now, and the 2/10yr segment showing the beginning of a tendency to steepen / dis-invert (from a state of deep inversion). Despite all of this, it is questionable how much room there is to the downside for yields. Anything below 3% for the 10yr looks too low here.

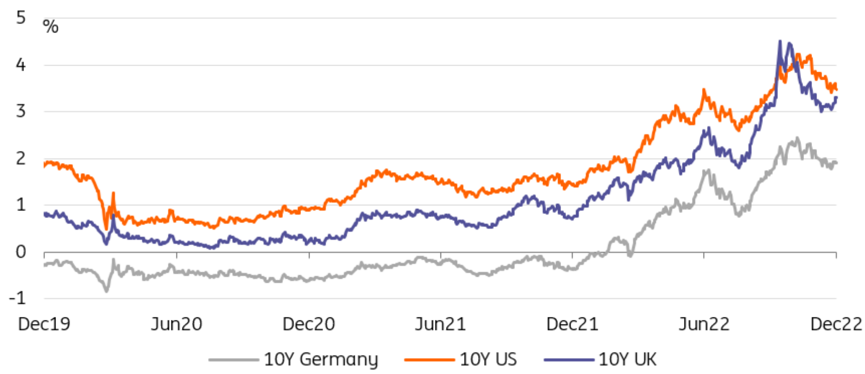
Market rates could still decide to trend higher. Yesterday's 10yr auction did suggest some resistance to buying at these levels. It will be interesting to see whether the Fed might frustrate things with any suggestion of bond selling (hard QT) going forward. The rationale would be to limit the ability for long yields to go too low too fast, and to downsize it's balance sheet.

The inflation flight is still on

On the CPI report itself, the 0.2% MoM outcome was largely pulled there by exceptionally large moves in certain components (e.g. used car prices). 60% of the index is "services less energy services", and that is running at a steady 0.4% MoM (which annualises to 6% inflation). That will be tougher to shift lower fast. The inflation flight is still on, the Fed is set to hike, and the bond market could well get a fright at a CPI report not too far from here.

For that reason, a hawkish 50bp hike is still expected from the Fed today. They could even contemplate some discussion of bond selling, or even simply entertaining that posibility. That would reverse things quite quickly, allowing the Fed to get more value from the delivered hike. Leaving the market braced for another hike in February 2023 is also probable.

European rates have less room to fall, with domestic inflation still not under control



Source: Refinitiv, ING

European rates struggle to join the US party

A striking feature of the post-US CPI bond rally is how sterling-denominated bonds struggled to follow their USD peers higher (lower in yields). The underperformance of EUR bonds relative to Treasuries was less spectacular but speak to an important theme as we head into 2023: it looks like the Fed is getting a grip on inflation much earlier than its European peers, and so US rates are in a better position to outperform until more tangible evidence of lower inflation emerges in the UK and eurozone.

It is much less clear European inflation has seen a peak yet

In the case of UK bonds, their underperformance was made worse by stronger labour and GDP data this week, and by a warning from Andrew Bailey against second round inflation effects. We see hawkish risk at both the Bank of England (BoE) and European Central Bank (ECB) meetings on Thursday. The difference with the US is that there is a greater chance that these hawkish warnings have a market impact as it is much less clear that European inflation has seen a peak yet.

Today's events and market view

The main release this morning is eurozone industrial production although this comes on the back of national measures which have taken the surprise out of the eurozone-wide measure. Spain's CPI reports is a final reading, and Italian unemployment completes this list.

US data has a few interesting releases too, including import prices and mortgage applications, but it is the FOMC meeting that will attract the most attention, especially after the second consecutive surprise slowdown in CPI in November (see above).

With regards to primary markets today the German debt agency will announce its issuance plans for 2023. There is a significant upside risk to this year's 230bn in bond issuance. To what degree the higher funding needs feed through to the bond target also depends on what other sources the agency will tap into, i.e. bills, repo or cash reserves. In any case, the market should expect more collateral.

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